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Letter Ruling 89-10: Limited Partnership Interest

August 22, 1989

You have requested a ruling whether a proposed subsidiary corporation ("Newco") will qualify as a security corporation under G.L. c. 63, § 38B. Specifically, you ask whether acquiring and holding a certain limited partnership interest would preclude Newco from § 38B classification because the interest is not publicly traded. We do not reach this issue because we find that this limited partnership interest is not a security.

Facts

("the Company") is a Massachusetts corporation and the parent company of an affiliated group of corporations filing a federal consolidated tax return. In addition to its manufacturing activities, the Company manages a portfolio of investments for its own account. The Company proposes to have a separate subsidiary, Newco, take over the investment activity. The Company currently owns substantially all of the assets that will be transferred to Newco.

Newco will engage exclusively in buying, selling, dealing in, and holding securities for the purpose of investment. The Company intends Newco to qualify for classification as a security corporation under G.L. c. 63, § 38B, conducting virtually all the Company's investment activities that come within the scope of the section.

As part of its investment activities, the Company sometimes invests in limited partnership interests that are not publicly traded. The Company currently owns the sole limited partner's interest in a limited partnership ("the Partnership") organized under the laws of the Commonwealth of Massachusetts. The Partnership has one general partner, which is unrelated to the Company.

The Company agreed to enter the Partnership as a limited partner after lengthy discussions and negotiations with the general partner. The general partner did not issue a prospectus or formal offering memorandum. The Company contributed seventy-three percent (73%) of the total original capital of the Partnership. The general partner contributed the remaining twenty-seven percent (27%) of the Partnership's capital.

By the terms of the partnership agreement, the general partner exclusively manages the business of the Partnership. Under the agreement, the Company cannot participate in the management or control of the Partnership. With the exception of the mortgage, pledge, or grant of security interests, the Partnership may not, however, sell, mortgage, refinance any mortgage, or lease the Partnership's facility without the consent of both the general partner and the limited partner, the Company. Nor can the Partnership change lenders for long-term borrowing or increase the amount to be borrowed over a certain limit without the Company's consent. The Company's liability with respect to the Partnership is limited solely to its capital contribution.

The partnership agreement provides that the Company has the right to assign its interest only to one of its corporate affiliates. In general, however, the Company may neither sell or assign its interest nor withdraw from the Partnership without the written consent of the general partner. The agreement further provides the general partner shall not unreasonably withhold consent.

Discussion

Chapter 63, section 38B, of the Massachusetts General Laws confers favorable corporate excise treatment upon a corporation "engaged exclusively in buying, selling, dealing in or holding securities in its own behalf and not as a broker." The exclusivity requirement of section 38B is strictly construed. See State Tax Comm'n v. PoGM Co., 369 Mass. 611, 612-13 (1976). If the Company's status as a limited partner in the Partnership does not constitute holding a security in its own behalf, Newco will not qualify for classification as a security corporation. [1]
The Department has ruled previously that a limited partnership interest can be a security within the meaning of section 38B. Letter Ruling 1982-8. On the facts you present, however, we conclude that the Company's interest in the Partnership is not a security for security corporation classification purposes.

In the absence of a definition of the term "securities" in section 38B, we consider the meaning of "security" in the securities laws. We recognize a central purpose of these laws is "to protect investors through the requirement of full disclosure by issuers of securities," a purpose that section 38B does not share. Compare Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (discussing purpose of securities acts) with Industrial Finance Corp. v. State Tax Comm'n, 367 Mass. 360, 364-65 (1975) (purpose of section 38B to encourage incorporation in Massachusetts). The characterization of an instrument as a security under the securities laws, however, is significant to the determination whether it is the type of instrument the Legislature intended security corporations to hold.

SECURITIES LAW

Investment Contracts

The definitions of "security" in the federal and Massachusetts securities acts do not specifically include limited partnership interests. [2] See 15 U.S.C. § 77 (b)(1)(1982); G.L. c. 110A, § 401(k). But see Unif. Securities Act § 101(16) (1985) (new uniform act includes limited partnership interest in definition of security). The securities law definitions are broad, however, and include the descriptive term "investment contract" to encompass unusual instruments if they are "widely offered or dealt in under terms or courses of dealing which establish[] their character in commerce as `investment contracts.'" Securities & Exch. Comm'n v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943), quoted in Commonwealth v. Baker, 368 Mass. 58, 70-71 (1975). An instrument may be an investment contract within the definition of a security if the transaction "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." Securities & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 301 (1946). Refraining from taking part in control of the business of the limited partnership is requisite to the limited liability enjoyed by a limited partner. See, e.g., G.L. c. 109, § 19(a). This fundamental passivity of a limited partnership interest would generally qualify an interest as a security for securities regulation purposes because it satisfies the Howey investment contract definition. Mayer v. Oil Field Systems Corp., 721 F.2d 59, 65 (2d Cir. 1983); see L. Loss, Fundamentals of Securities Regulation 190 (1988).

Whether a particular instrument is an investment contract, however, depends not on form, but on the economic substance of the transaction. Landreth Timber Co. v. Landreth, 471 U.S. 681, 688-89 (1985) (applying Howey test); see Marine Bank v. Weaver, 455 U.S. 551, 560 n.11 (1982) (whether agreement is security depends on content, purposes, factual setting). Instruments that represent the negotiated terms of a private, one-on-one transaction must be distinguished from those that are unilateral offers to many potential investors. See Marine Bank, 455 U.S. at 559-60; Bank of Am. Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assoc., 595 F. Supp. 800, 805 (E.D. Pa. 1984) (documents representing bargained terms in individual transaction not securities). A security is "an instrument in which there is `common trading;'" instruments held to be investment contracts in earlier cases "had equivalent values to most people and could have been traded publicly." Marine Bank, 455 U.S. at 559-60 (quoting Securities & Exch. Comm'n v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).

In holding the agreement at issue in Marine Bank v. Weaver was not a security, the United States Supreme Court noted there had been no prospectus distributed to the respondents or to other investors. Id. at 560. The Court pointed out that the unique, negotiated agreement was not designed to be traded publicly. Id. The Court also mentioned that a provision giving the respondents power to veto future loans gave them a degree of control over the management of the business not typical of a security. Id.

Interests in Limited Partnerships

The problem of determining whether a limited partnership interest is a security has been likened to distinguishing "the public offering of securities parading as `limited partnership interests'" from "`an offering of a half interest in a hamburger stand.'" L. Loss, supra, at 192. Where there was a public offering of interests, or an appreciable number of limited partners involved, courts have held the interests were securities. Mayer, 721 F.2d at 65 (citing cases including Securities & Exch. Comm'n v. Holschuh, 694 F.2d 130, 137 (7th Cir. 1982); Securities & Exch. Comm'n v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980); Goodman v. Epstein, 582 F.2d 388, 406-08 (7th Cir. 1978), cert. denied, 440 U.S. 939 (1979); cf. Marine Bank, 455 U.S. at 559-60 (unusual instruments held securities involved offers to a number of potential investors, not private transactions). Where sole limited partners acquired their interests not through a public offering, but as a result of a negotiated agreement, the interests have not constituted securities for purposes of securities regulation. Bank of America, 595 F.Supp. at 806-07; accord Bamco 18 v. Reeves, 675 F.Supp. 826, 830-31 (S.D.N.Y. 1987) (interest of sole limited partner in one-project endeavor acquired after one-on-one negotiation not a security.)

The Company's Limited Partnership Interest

Like the respondents in Marine Bank, the Company acquired its sizeable limited partnership interest in the Partnership not on the basis of a prospectus, but after one-on-one negotiations with the general partner. The agreement limits the transferability of the interest, which is not designed to be traded publicly. Furthermore, we note the agreement gives the Company a measure of control over future financial dealings of the Partnership similar to the authority the Court identified in Marine Bank as uncommon to holders of securities.
We recognize that many limited partnerships, especially those that are freely transferable, sold through public offering, and traded on stock exchanges, may be considered to be securities for purposes of securities regulation. See L. Loss, supra, at 190-91. We find here, however, that the Company's limited partnership interest in the Partnership more closely resembles "a half interest in a hamburger stand" than a security for purposes of securities law.

Section 38B Security Corporation Classification

Characterizing any instrument as a security in the context of securities regulation would not necessarily establish the interest as a security for purposes of section 38B of chapter 63 of the General Laws. Conversely, however, an instrument that is not a security for securities law purposes is unlikely to be the kind of security the Legislature intended a security corporation to hold. Accordingly, we find the Company's limited partnership interest in the Partnership is not a security for purposes of section 38B. Inclusion of the Company's interest in the Partnership in Newco's portfolio will disqualify Newco from classification as a corporation engaged exclusively in managing securities. See Chatham Corp. v. State Tax Comm'n, 362 Mass. 216, 219 (1972). [3]

Very truly yours,
Stephen W. Kidder
Commissioner of Revenue
August 22, 1989
LR 89-10

Footnotes:

1 Much as the purposes for which an asset is acquired cannot be transformed by transferring the asset to a wholly-owned subsidiary, similarly, the nature of the Company's Partnership interest will be the same in the hands of Newco. Cf. Letter Ruling 89-2.

2 The definitions of security in the federal and Massachusetts acts are the same. Compare Securities Act of 1933 § 385, 15 U.S.C. § 77(b)(1)(1982) with G.L. c. 110A, § 401(k). In interpreting the Massachusetts statute, courts may consider decisions under the federal act. Valley Stream Teachers Fed. Credit Union v. Commissioner of Banks, 376 Mass. 845, 857-58 (1978).

3 The Company withdrew its request for a letter ruling before a ruling was issued. We nevertheless publish this document to inform the public of the Department's position on the important issues that it addresses.

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